Decentralized Discipline and the Roles for Principles

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It is a great honor for me to be invited to this 25th Anniversary Conference of SESC and to speak before the distinguished guests and professionals.

Today, I wish to share with you some of my thoughts for a better performance of the capital market with some emphasis on the principles-based approaches. (page2) To this end, I should like first to introduce my recognition that decentralized discipline is inevitable and indispensable in the capital market. Then I will touch upon the comparison between rules and principles. Third, I wish to share with you my notion of the decentralized discipline in the capital market, and wish to speak on why principles could be effective in this mechanism. Finally, I would like to briefly introduce to you the recent development of widening use of principles-based approaches in Japan.

1. Decentralized Mechanism of the Capital Market

From my personal experience, I have been daily persuaded that the capital market is indeed functioning on the basis of appropriate division of labor and harmonious cooperation among diverse market players and market intermediaries. At the self-regulatory arm of Japan Exchange Group, I am currently in charge of listing examination, listed companies' compliance, market surveillance and securities houses inspection for both the Tokyo Stock Exchange and the Osaka Exchange. (Slide 1) From this viewpoint, I realize that any capital market failure or disorder originates from the misconduct or malfunctioning at one or two elements within this huge mutually dependent system.

Let us take the typical example of listed shares. (Slide 2) Listed companies issue equities and finance their activities. In turn, they are required to maintain good corporate governance and to disclose their performance by regularly issuing financial and other reports to the investors. Investors make their investment judgments on the assumption that these reports disclosed by each listed company are accurate and reflecting the reality. Furthermore, they are expected to provide meaningful comparability among listed companies. In this connection, it is needless to say that the roles of high quality accounting standards and reliable auditing are of utmost significance. If listed companies and investors are classified as major market players, accounting standard setters, auditors, analysts, lawyers, securities companies and stock exchanges are all important market intermediaries in a broad sense. Without appropriate business exercise by these diverse entities, the smooth functioning and the sustainable integrity of the capital market would be at stake.

In this situation, I think that the capital market is destined to rely on the discipline maintained by each individual market player and intermediary. (Slide 3) "Decentralized discipline", as I call it, is expected to play an indispensable role for achieving and sustaining market transparency and fairness. So, the capital market is daily faced with the difficult challenge of how to let this decentralized discipline work effectively to bring about overall consistency and integrity at the market. Professional expertise and high moral on the part of each intermediary are indispensable, but we cannot solely rely on its voluntary efforts, because the levels of professional competence differ among intermediaries. Also, in fact there exist occasionally professionals with low morals and low ethical standard. Indeed, this is where rules-based regulation and supervision are needed to provide common standards and to guarantee minimum performance in each professional area.

2. Rules vs Principles

Here, let me touch upon the characters of rules and principles, which are both important components of capital market discipline. In 2007 the Better Regulation Initiative was launched and introduced by the Financial Services Agency. (Slide 4) The initiative consisted of four pillars, and the optimal combination of rules-based and principles-based supervisions stood as its first pillar.

The FSA's thoughts then on the relation between rules and principles are roughly shown on Slide 5. They regarded rules and principles as being complimentary to each other in financial regulation. We live in an era of financial innovations taking place one after another. In this situation, it is almost impossible to foresee accurately future changes in products, distribution channels and business models, and therefore impossible to cover all the cases by rules in advance. They thought that principles could cover the gaps arising between old not-yet-revised rules. Furthermore, in applying rules to individual cases, principles could provide valuable guidance across various individual judgments and could help attain consistent equality, because principles-based approach looks into real substance rather than visible forms alone. They also thought that principles would encourage financial institutions to think on their own and to strive toward their best practice.

Such reasoning was typically reflected in the “Principles in the Financial Services Industry”, which was compiled and announced in April 2008. (Slide 6) These 14 principles are meant to induce financial firms to share the common social values and to strive towards desirable business management, and thereby encourage them to provide higher quality services to their customers.

We should recognize, however, that principles have their own weak points. Slide 7 compares the merits and demerits of rules and principles. The interpretation of principles is often left to each individual entity, which creates discrepancies in the degree of compliance. Principles are not necessarily accompanied by strong enforcing powers, thus they sometimes turn out to be ineffective to committed wrong-doers. On the other hand, rules are destined to produce gaps between themselves over time due to the financial innovation and changing circumstances. Rules alone approach sometimes allows for disguised fair (and in fact unfair) trading pretending to be fully compliant to rules superficially. The enforcement of rules also faces the problem of limited availability of regulatory and supervisory resources.

While keeping these characters of rules and principles in mind, I think that principles are able to play essential roles, if they are appropriately defined and well positioned, because they are the origin of disciplining power and incentivizing force. (Slide 8) Principles are the foundations of reasoning and standards of behavior which, if widely shared among relevant entities, could always be referred to as reliable common guidance in business judgment and execution. They are the product of chemistry, where the originally abstract and implicit sense of norm born by people in various corners of society one day encounters principles and obtains concrete and explicit expressions. Taking capital market as an example, “maintaining fair and transparent market”, “protecting investors”, and “efficient price formation” are the typical values. In fact, they are often the fundamental spirits of written laws and rules, too.

In other words, principles-based approach is a regulatory method in which the authority directly appeals to each entity's sense of norm through compiling sets of principles (explicit behavioral standards). Also, the authority could incentivize or persuade the entities that principles-consistent behaviors will enhance their own interest. It could be paraphrased as a framework where the recognition and sharing of common social benefits will induce each entity's behavior to a socially desirable outcome. It requires the acceptance of the core values and norms, but it allows for different approaches and paths to reach the final target. Thus, the prevalence of principles would enhance the sense of norm and be widely incorporated in market practices, and thereby provide a basis for sustainable and effective decentralized discipline.

3. *Disciplining capital market through principles*

Now, the challenge is how to incorporate the rules and principles into the decentralized disciplining mechanism in order to achieve the overall consistency and integrity of the capital market. This is not a simple task. While keeping it in mind, allow me now to turn to today's main theme: what roles can principles play in disciplining capital market?

Let me reiterate that the performance of a capital market largely depends on how the decentralized discipline prevails. I would paraphrase the term "decentralized discipline" as a mechanism where the sense of norm and compliance influences each market participant or intermediary in line with their relevant professional requirements against the background of rational institutional framework and appropriate incentive structure. And hopefully, the aggregation of thus motivated behaviors enhances the orderly functioning of the market as a whole.

Slide 9 presents my image of the sustainable functioning of a reliable and competitive capital market. The attributes shown in the left box need to be maintained over time, and the sustainability of these attributes brings about the dignity, competitiveness and future development of the market. They are the high quality of financial products, fair trading and reliable execution, confidence in disclosure system, convenience for investors and issuers, vitality with the financial services industry, and, as a result, reliable price-discovering function. I would insist that it is the effective disciplining mechanism that assures the sustainable functioning of these necessary attributes. As I see it, this disciplining mechanism includes (i) the common sharing of norms, (ii) the existence of appropriate incentives, (iii) the transparency and predictability of regulation, (iv) the fair and effective supervision, (v) the business evaluation through efficient market mechanism, etc.

The components of the disciplining mechanism stated above could be regarded as causes and/or results of the three basic categories, i.e., (1) regulatory discipline exercised by authorities, (2) market discipline exercised by the price mechanism, (3) self-discipline exercised by each market participant or intermediary. Let us look into the overall mechanism in which these three disciplining vectors work together and are supporting one another. Slide 10 illustrates my image of how the decentralized disciplining mechanism works in the capital market. As is shown in the central circle, rules, principles and disclosures are the basic nutrition that support and strengthen the regulatory discipline, the market discipline and the self-discipline. Assuming that the regulatory authority establishes and supports the well-functioning of the disclosure system, the regulatory discipline strengthens the market discipline in addition to its direct influence on the self-discipline. The market discipline enhances the self-discipline through relevant entities' mutual dialogue and through the price mechanism. In this way, supported both by the regulatory discipline and by the market discipline, the self-discipline functions more effectively and more powerfully towards diverse market participants with the aid of principles.

The Slides 11 to 13 describe the characters of each of the three disciplining vectors. Slide 11 shows that the regulatory authority is responsible both for setting and enforcing rules and for compiling and disseminating principles. It is supposed to play the roles of ensuring the effectiveness of regulations and of strengthening the sense of norm and preventing inappropriate conducts in advance. Slide 12 emphasizes that based on the timely and appropriate disclosure and efficient price mechanism, the market discipline continues to function seamlessly without much regulatory resource. Slide 13 proposes that the self-discipline is , in a sense, inherent in every decent rational human being, and that it can be turned into solid behavioral standards when coupled with good principles. The self-discipline is enhanced both by the regulatory- and the market-disciplines.

So, my conclusion is that principles can play a great role in disciplining the capital market through the cooperation with good regulation and market participants' integrity.

4. *Recent Development in Japan with Principles-based Approaches*

Before closing my speech, I wish to present to you briefly some recent development in Japan with regard to the principles-based approaches being used in financial regulation. In fact, the principles-based approaches are getting more and more common in these days, especially with regard to the capital market regulation, as is illustrated in Slide 14.

I am also personally happy to see this development, because I was directly involved in compiling "The Principles in the Financial Services Industry" in April 2008. Several months later the Lehman Shock intruded in September, with which much of the regulatory resources were forced to shift to crisis management and post-crisis recovery. However, after some years of standstill in this area, Japan's Stewardship Code was introduced in 2014. Combined with Japan's Corporate Governance Code which was introduced next year, they constitute the fundamental behavioral standards now for all the listed companies in Japan and the major institutional investors in their effort toward enhanced sustainable growth in corporate value in medium- to long-term.

My organization, the Japan Exchange Regulation, also compiled "The Principles for Equity Financing" in 2014 and "The Principles for Responding to Serious Scandals at Listed Companies" in 2016. This year, in 2017, two further principles were compiled by J-FSA, one on the fiduciary duty and the other on the management of audit firms.

Finally, I wish to touch upon the "comply or explain" regime. (Slide 15) I think this is a wonderful invention to ensure the effectiveness of principles-based approaches. In addition, this regime is akin to and consistent with the philosophy of the self-discipline. As a matter of fact, both the Corporate Governance Code and the Stewardship Code have adopted this scheme. It is also very useful in inducing the listed companies to think on their own whether they should comply a certain principle or not, and to evaluate their status quo to what extent it is compliant. Since the results of their "comply or explain" situation are disclosed, this regime invites the market discipline to work together, as well.

We have entered the third year with the Corporate Governance Code. At this stage I observe from our experience one issue worth considering. That is the possibility of “comply <u>and</u> explain”. Since it is each listed company itself that evaluates whether it is compliant with a certain principle or not, there could arise some differences as to the degree in accuracy and integrity of each judgment. In some questionable cases, it might be useful for the listed companies to explain why they think they are compliant to the relevant principle.

So, we have to continue to learn.

Thank you.